DOW THEORY LETTERS INC.

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THE MARKET: I have received a tremendous amount of mail over the past week or so. Two of the correspondents are men for whom I have the greatest respect, and I feel that it is worth paraphrasing what they said. A letter from Anthony Gaubis of New York (a leading investment counselor) warns that although he is afraid the coming bear market may be on the order of 1906-07 or 1937-38 (two of the severest bear markets on record), he nevertheless expects a substantial retracement to start soon. Both the aforementioned bear markets, Gaubis notes, "started out with initial set-backs of 15%, which were followed by retracements of more than two-thirds before there was a real change from the preceding one-sided psychology." Gaubis expects an important recovery movement to start in June and last to election time in November. But at or near election time he feels the real bear market forces will assert themselves on the downside.

Economist Eliot Janeway called me from San Francisco, after having delivered a very bearish and widely quoted speech in Los Angeles ("They almost ran me out of town," he confided). Janeway said that he feels we are in for another 1919 (at that time a speculative boom ran into tight money conditions, and the resultant deflation in the economy and the stock market was extraordinary in its severity). Janeway believes that Government fiscal agencies are now at odds with each other, and that the Vietnam war has become a tightening noose around the neck of the economy. He expects more money troubles, higher interest rates (Government bonds at yields of 6%), and he notes that the current monetary distress is world-wide, not local. World money crises, he notes, are harbingers of depression, not recession.

What is my own opinion of the near-term prospects for the market? Frankly, I'm not convinced that it is necessary to have a near-term position. I do not wish to out-trade or "beat" this bear market, and I feel reasonably certain that if I start hopping in and out in an attempt to catch rallies or declines, I am going to start thinning out my bank account.

The signal for a primary bear market was given by the Averages on May 5. The signal came during the second downward leg of the bear market, a leg which

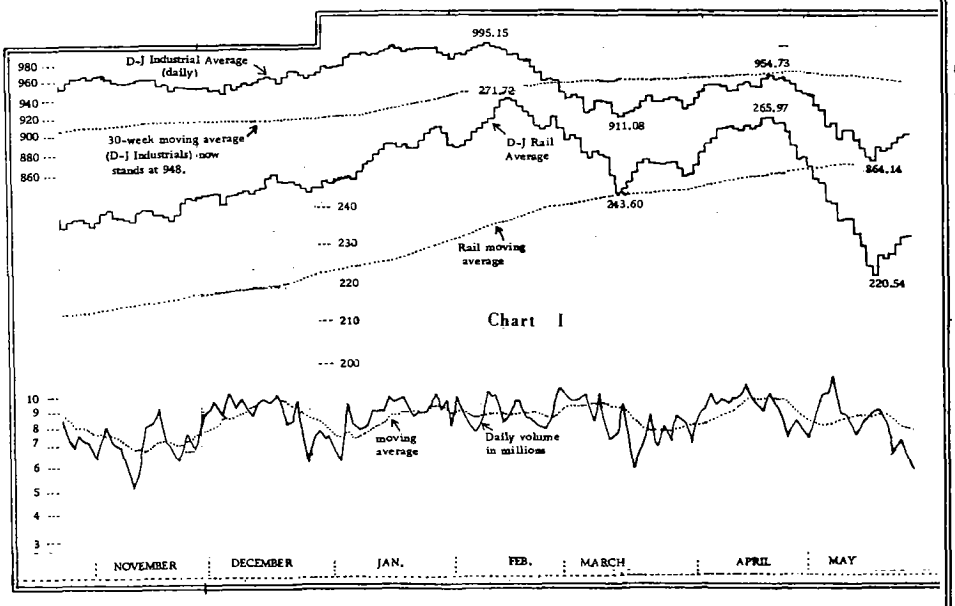
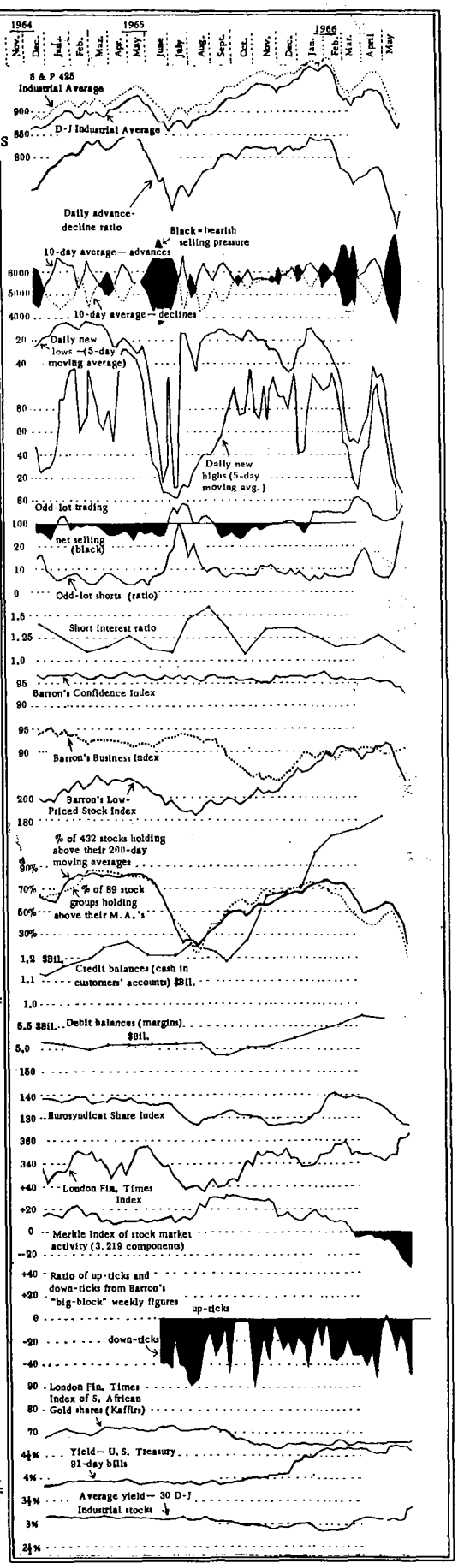


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

started on April 21 at 954.73 for Industrials. By May 17 the Industrial Average had sunk to a low close of 864.14, 131 points (on a closing basis) below the February bull market peak. The decline produced extraordinary downside compression. There were more than 800 daily declines during 10 of the 21 trading days between April 21 and May 17, and four of the downside days produced daily declines in excess of 1000 issues. At the May 17 low the advance-decline ratio had broken below the 1965, the 1964 and the 1963 (the Kennedy assassination) lows back to the lowest point since December, 1962! The fact that the Dow held above the 1965 low of 840.59 constituted a downside non-confirmation between price and breadth. The price-breadth non-confirmation (in favor of the Dow) now allows for a rally of possibly extensive proportions. As a guide, a 50% retracement of the entire second primary bear leg could take the Dow back to 909 or roughly within striking distance of the 911.08 bear signal level. At 911, I would expect heavy resistance to further progress. Time will tell, but in the meantime, I suggest that all subscribers who have not eased out of the market accept this rally as an opportunity to sell.

The "standard" measurements for an "oversold condition" have been much in evidence. As seen on the composite chart, odd-lot shorts are running high, only 22% of all stocks are holding above their moving average, only two Dow stocks (Alcoa and Kodak) are still bullish. This week Barron's Confidence Index dropped a whopping 1.3 to 92.6, thus sinking to another two-year low. It should be remembered that in bear markets the oversold conditions will tend to be more drastic than in bull markets, while overbought conditions will be milder. Meanwhile, many analysts are waiting for the "big high-volume selling climax" which supposedly should mark the conclusion of the second primary leg. It may or may not appear—and then again, it could come in June or later, following the conclusion of the current rally.

NOTES AND QUOTES: Some men seem fated for a rendezvous with disaster. Occasionally, it is an outside event (such as the Great Depression during Hoover's time) which produces the rendezvous, and sometimes it is a defect in the character or vision of the man himself which draws him and his followers towards calamity. "How all things do inform against me," cried Hamlet in a moment of anguish.

I feel that both fate, character defect and a lack of vision are moving President Johnson's steadily toward disaster. The bear market is not of Johnson's making, it is unfortunate, and he will have to deal with it as best he can. But the Vietnam situation has developed partly as a result of President Johnson's series of ghastly miscalculations. More important, the President seems to lack any ability to admit that he can be wrong. He has been indulging in the fatal political mistake of "burning his bridges behind him." He did this when he backed Premier Ky (see my objection to this in Letter 315). He has done it again and again since, the latest instance being his speech of May 18 at a Democratic fund-raising dinner. At that time he stated categorically that the U.S. was committed in Vietnam, come what may. He then attacked the "nervous nellies" who will become frustrated and bothered and break ranks under the strain and turn on their own leaders, their own country and their own fighting men.

In my humble opinion these are the thoughts of a President who has a rendezvous with disaster. They are the thoughts of a man who struggles ever more wildly as he sinks into the quicksand. I have always felt that when the basic premises of a position are wrong, then no amount of juggling or luck can result in that situation turning out favorable. In my opinion, Johnson's basic premises on Vietnam are wrong. As an interesting aside, it might be noted that President Johnson is the first Democratic President within modern memory who has not had the backing of the intellectual and University element of the nation. The President never had the backing of conservatives, he has now lost the backing of the intellectual leaders of the Democratic party. His next loss will be the people.

* * *

On April 21 economist Eliot Janeway interviewed financier Ferdinand Eberstadt, one of America's elder statesman (he is the father of World War II's plan for industrial mobilization). I thought part of that interview was worth repeating here. "Janeway: Has the crisis in Viet Nam involved us in an exercise in fiscal brinkmanship? Eberstadt: Definitely—and its beginning to get ahead of us. When you use money for productive purposes, you don't get inflation. You get inflation when you use money unproductively as in war. Then everybody's costs go up and real earnings and savings go down."

"Janeway: Can emergency taxes and controls hold the line? Eberstadt: Not for long. But when once a society puts a stop to unproductive expenditures, the inflationary fever cures itself. Janeway: Will the fiscal score be toted up by the way we play the game in Viet Nam? Eberstadt: I'm just a stuffed shirt Wall Street Republican, and L.B.J. is a master politician from Main street. But I hate to see him try to climb up the side of a fog bank. That's what we've been doing out there— and with no social structure to grasp onto. The way things are now, if we should win, we lose as white imperialists; while if we are beaten, we are just plain punks. Janeway: How do we work our way out of this bind? Eberstadt: To make the other fellow sit down and talk you must show him that he has something to lose if he doesn't. Now, the enemy has nothing to lose. We have committed ourselves not to threated the big fellows on the other side. Why should they negotiate? Our policy is exhausting our own resources. The other side has made pretty good progress with its plan or we wouldn't be talking about inflation today."

* * *

From the May 21 London Economist: " When Marshal Ky flew his marines into Da Nang last Saturday night he meant to pull the rug from under the Buddhists; but it was President Johnson who found himself standing on thin air. It is not only Marshal Ky's personal credibility that was fatally damaged by this attempted double-cross. He deceived the Buddhist leaders, who knew he was arguing about the scope of the election promised by September (would it elect a new government, or just a constitution-drafting assembly?), but did not know he would try to scrap the whole deal. He also, even more foolishly, deceived the Americans, who apparently had no warning of his pounce on DaNang.

In a war like Vietnam's a man can play dirty tricks and still qualify as a leader. But the really important thing that has been destroyed in this week's mess is Marshal Ky's standing as a leader capable of pushing ahead with the fight to keep South Vietnam out of communist hands. "

DOW'S THEORY: Anyone who has an interest in the market must have read at least two dozen different investment services and assorted opinions at around the time this market was "topping out" (during February to April). A great bull market inevitably creates interest and excitement, and, as I have often noted, it also spawns a great many new market systems, theories and investment services. Many of the new services were based on a single "indicator" or a combination of various "new" indicators. Thus at the top we heard such statements as "the market can't top out with debit balances this high," "it can't top out with an 11 million short interest," " a bull market has never topped out in February," or "the disparity index and the new peak in the low-priced stock index point to new highs in the Averages." Would that it were so.

At times the market makes fools of us all. No system works perfectly all the time, and some work less perfectly than others. But, as anyone who has kept up with any number of other services knows, this bear market has made utter hash of the majority of systems. Bear markets have a nasty habit of doing just that.

All of which is exactly why Dow's Theory lasts. Throughout the last six decades many market methods have come and gone, but only Dow's Theory has stood the test of time. When you need it, it is there, issuing it's predictions of bull markets to come, of bear markets to come, or simply waiting for the Averages to clarify the issue. True, there have been false Dow Theory signals, and there have been signals which were followed by sub-normal movements in the direction of the signal. But then Dow's Theory has never been advertised as the perfect device to beat the market. The day such a method is invented, the market will cease to be.

Applying Dow's Theory to the market is an art, not a science. Accuracy could undoubtedly be improved if one's skill at "reading the averages" could be improved. But that takes time—and experience. In November, 1937, Robert Rhea wrote: "I have often said that no man is likely to become a competent Dow Theorist until he has studied the Theory against the actual movements of the Averages for a good many years, and has watched its operation through at least a complete bull and bear cycle."

This generation has never seen a true primary bear market in action, and those of us who follow Dow's Theory are watching events with utmost interest. For we are now witnessing Wall Street's "Baptism of fire," and for many this is the rounding out (I hope not the painful rounding out) of their market education, a study of the aftermath of a great period of excess and speculation.

Those of us who believed in Dow's Theory, acted on the implications of the Averages during February and May. If we had not sold out by May, we cleaned out on the implications of the bear signal. We are now in cash, and in excellent shape to weather shocks and panics the bear market may bring. We will depend on our studies of Dow's Theory to guide us through the treacherous currents of the bear market, until one day we will witness the ebbing of the bear tide and the birth of a new bull market. Solid fortunes will be made by buying correctly at the beginning of the next bull market, and it may be of some comfort to know that it is generally easier to call the beginning of a bull market than the beginning of a bear market. But the overriding job for us at present is to stay solvent and financially intact so that we will have our funds available when we need them. It is no exaggeration to say that more people go broke during the second half of a bear market than the first. Impatience and greed prompt incorrect buying before the bottom, and swimming against the tide of a bear market is a costly exercise. Some of the time-tested gauges of indentifying true bear market bottoms will be discussed in forthcoming Letters.

PRIMARY TREND: In Letter 319 I discussed the implications of the most powerful force in the market, the primary trend. I wrote, "Once the best has been fully discounted by the Averages, conditions cannot get any better (by definition), they can only get worse on a long-term basis. Thus during a bear market time is on the side of the bear, because values during a bear market decrease through time."

A few lines later I continued, "The primary trend is the great tidal movement in the economy and the market. Like the tide of the ocean, the primary trend ultimately sweeps all before it. When the primary trend turns up (i.e. a bull market), it can be said that the long-term outlook for business, personal investment, stocks, real estate and corporate profits is favorable. Conversely, when the primary trend turns down (i.e. a bear market) the prognosis for all types of investments (with a few exceptions such as gold shares) is poor. During a bear market the value of 'things' declines, people have less money, profits and dividends from investments are reduced, and the outlook for all types of business is unfavorable."

Robert Rhea, the great Dow Theorist of the 1930's, put it better than I did. In January, 1938 he wrote: "All the shares of every corporations are, of necessity, owned each night. Shrinking securityvaluesmean for thousands of people the abandonment of hopes for the new home or car, or perhaps for the education of children. When spending is curtailed, then industry sells less of its products and employment decreases, thus bringing misery to additional thousands, and losses to industry which cause dividend reductions that further reduce individual purchasing power. Industries' troubles are not limited to losses caused by declining orders. Equal or greater losses come from shrinkage in the value of fuel, copper, leather, cotton and other inventories held in raw form, in process of manufacture or on shelves. The development and progress of the condition cited induce what we call a bear market in stocks and a depression in business, and is caused primarily by an exactly opposite situation to the one which created the preceding bull market."

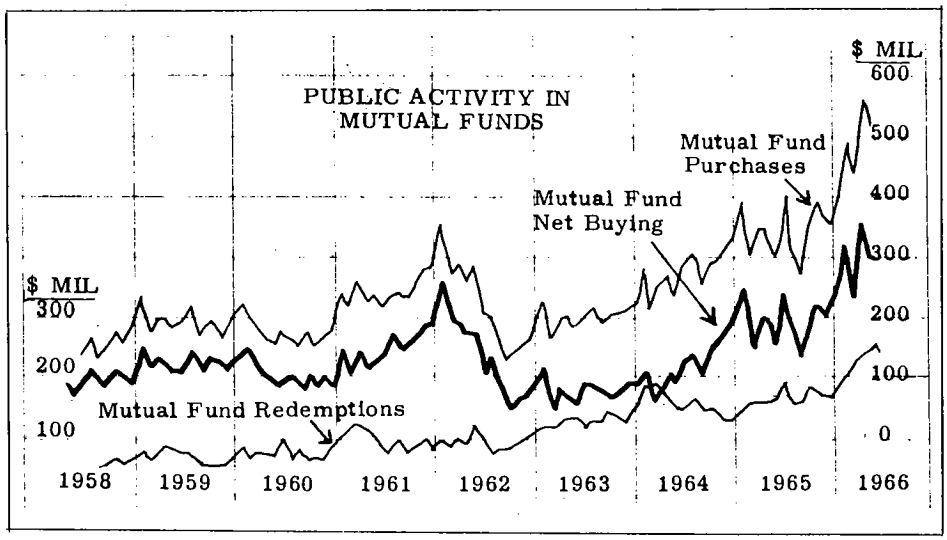
I want to stress again the relentlessness of the primary trend. The primary tide is not a mistake, a miscalculation or a result of the Federal Reserve Board "pushing the wrong button." It is a tide in human affairs, and it must express itself fully before it dies in exhaustion. "But what could cause this change in human affairs?" asks the subscriber. The answer is that the tide is made in the minds and the energies of men. The tide, being a true expression of mass psychology, is a living thing. What is alive must eventually grow old and die. When the bull dies, the bear takes over, purging the poisons and excesses from the corpse of the bull. And ultimately, when the excesses are removed, a new bull market is born. It has been this way throughout all recorded history. It will remain thus as long as men have hopes, and as long as hopes lead to industry and dreams, and as long as industry and dreams lead to speculation, and as long as speculation leads to excess.

But it is the turns, the rare changes in the primary trend which are so difficult for men to comprehend.

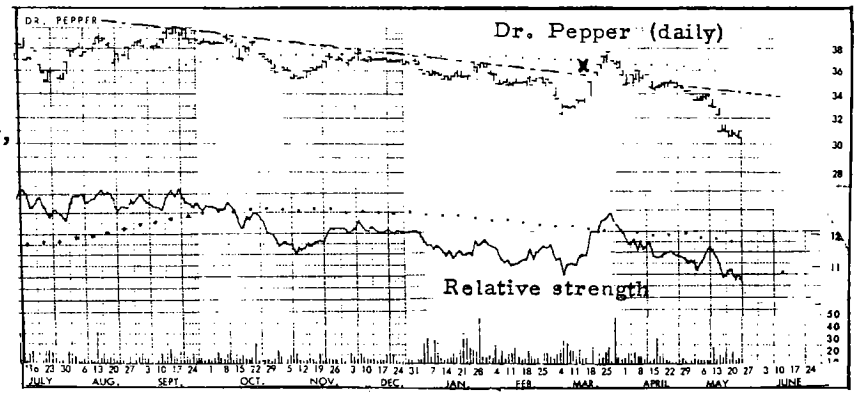
There is a psychological inertia which seems to keep people thinking along the same lines far past the point where conditions change. It is this inertia which keeps men invested through the years, and it is this inertia which eventually allows them to ride their investments over the brink into a bear market.

"There is always a disposition in people's minds to think that existing condition will be permanent," wrote Charles Dow. "When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous it is always said that while preceding booms have not lasted, there are circumstances connected with this one which make it unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change."

CHART OF THE WEEK: The accompanying chart (courtesy of Value Trends, Box 12069, San Diego, Calif.) is of particular interest at this time. The heavy black line shows net mutual fund purchases (purchases minus sales). Note that the last peak in net purchases came in early 1962, just before the violent 1962 collapse. Then, as recently, the public seemed to be buying shares of mutual funds with abandon. The March, 1966, purchases of funds rose to the highest level in history. As the chart shows, it required four years, following the 1962 crash, before the public was willing to load up on funds on a scale surpassing the rate of early 1962.



STOCKS: In Letter 317 I listed 10 stocks for those intrepid subscribers who wanted to try their hand at shorting. Most of these stocks, if shorted at the time, would have produced profits. But it isn't easy, and Dr. Pepper (one of the 10 listed) provides an example of why it is so exasperatingly difficult to come out ahead on the short side.



I recommended shorting DOC at "x" as shown on chart. DOC had been sliding down below a long descending trendline. DOC's relative strength line had been steadily breaking down, indicating that the stock was acting worse than the market on a long-term basis. Following the recommended short on DOC at about 34-35, the stock unexpectedly broke sharply out of the trendline, while relative strength pushed to the highest level since last October. I received a number of calls from subscribers asking "What now?" I said, "Hold tight, as the stock has now pushed up into the supply area which was established last November and December in the 38-39 area. If it holds at 39 or better, then rallies again—'cover'."

A day or so later DOC reversed to the downside. It has been hitting the new low list ever since, having fallen 5 points below the recommended shorting area. Relative strength has also dropped to new lows. What caused the rally? It was probably just a deceptive technical rally, but it sufficed to throw doubt on the whole trend analysis. Was it worth shorting the stock and sweating out the rally, even though 5 or 6 points were finally gained on the short side? I'll be darned if I know. Personally, I can live without this kind of money. It's too hard on my sleep. Other tougher souls may philosophically feel that it's all part of the game. At any rate, what occurred with DOC is typical of what you may expect on the short side, even though you may come out with profits in the end. DOC also illustrates why I stated that shorting is not for the great majority of my subscribers. It's too tough a game. Chart of DOC courtesy of Traders Research, 1431 Pearl St., Alton, Illinois 62003.

LATE NOTES: News clips like those at right now punctuate the financial pages. Tight money is beginning to damage the economy, and money is getting still tighter. Mortgage money is disappearing, threatening to grind the construction industry to a half (latest figures show total number of construction jobs in San Diego County dropped a whopping 49.3% in April as against last year). The "safety scare" is being blamed for the slowdown in auto sales, but here the problem of financing is bound to exert its effect. I feel that the fundamental situation is not being fully grasped by the public of the professionals. The attitude seems to be, "All right, the bad news is out—so what!" But in my opinion the bad news is going to become worse, and a monetary squeeze of extraordinary proportions is going to assert itself.

In a bear market it is worth watching the D-J Averages, Industrials, Rails, Utilities and the 40 Bonds. Last week the 40 Bonds continued to drop to the lowest level in four years. In time, I feel the other Averages will join the 40 Bonds.

Some Leading Banks In New York Offering 5½% on 6-Month CDs

Previous High Was 5.40%; General Electric Credit Says It Will Pay 5½% on Paper of 30 to 270 Days

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—The nation's largest banks and finance companies opened a new round in the continuing battle for funds of corporations and institutional investors.

A change in the posted interest rates on large-denomination certificates of deposit issued by leading New York banks showed some were offering 5½% on CDs maturing as early as six months. The previous top posted rate was 5.40% on 180-to-270-day CDs.

Regular Savings Payout Of 5% OKd For S&Ls

Compiled from The San Diego Union News Services

WASHINGTON — The Federal Home Loan Bank Board yesterday acted to let savings and loan associations pay higher rates to attract savings.

The board said it will allow California and Nevada associations to pay up to a 5 per cent dividend on regular passbook savings accounts without losing their borrowing power from district Home Loan Banks. (A number of associations, including some in San Diego, already are paying 5 per cent on passbook savings.)